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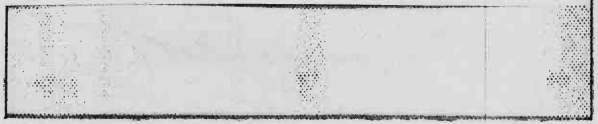

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STATEMENT OF

MR. FREDERICK STRAUSS

BEFORE THE

INTERSTATE COMMERCE COMMISSION

ON THE

Advisability of the Commission's Permitting the Issuance by Carriers of Shares without Par Value

MAY 26, 1921

CHAS. P. YOUNG CO., Printers, 190 William St., N. Y.

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May 26, 1921.

The Railroad Securities Commission of 1910-1911, of which Mr. Hadley was Chairman and of which Commissioner Meyer and myself were members, was composed of five members. The other members were Mr. Walter L. Fisher and Mr. F. N. Judson. Although the views of the members differed widely on many subjects at the time of the first conference and at subsequent conferences, the members came to a unanimous agreement after a study of the subject extending over nearly a year. Among the subjects considered and reported on was that of the issue by railroad companies of shares of no par value. This subject was examined into with the greatest care and much discussion was had on the subject. The notes made by me at the time bearing on this subject are quite voluminous and indicate that much thought was given thereto. The Commission reported in favor of carriers being permitted to issue shares of no par value. On reflection I am

more than ever convinced of the wisdom of that Commission's recommendation in this respect and of the action of the many states that have recently passed acts enabling railroad corporations and public utility companies organized under their laws, to create shares of no par value. The States of Missouri and Kansas have passed such acts within the last two months. If the Chairman will permit me to do so I shall be glad to leave with you a copy of the report of the Railroad Securities Commission with certain passages marked, so that it will be easy, without having to read the entire report, to see what were the views of that Commission on this subject. In presenting my views here to the Interstate Commerce Commission, I have frequently made use of the phraseology employed in the report of the Railroad Securities Commission.

Broadly speaking, there are two economic grounds on which my advocacy of the use of shares of no par value is based:

(1) The most important of all principles of sound finance is that the superstructure of credit shall rest on an adequately firm base of capital. Without this the stability of the financial structure is impaired by an ever-growing debt with ever-growing fixed charges. With shares having a par value, it is under existing laws governing the issue of such shares, difficult and in many cases impossible to effect a sale thereof at less than par. In the case of a carrier, the stock of which sells below par, all money must, therefore, be raised by the sale of bonds. It has to go into debt more and more deeply. The worse its financial condition the stronger is this compulsion and the heavier

become its fixed charges. The requirement that no stock should be sold at less than par would be sound if it resulted in the sale of stock at par, but surely it is unsound if it results merely in the sale at a considerable discount of bonds bearing extremely high rates of interest. The sale at a discount, even if permitted by law, of a stock having par value, especially if issued under Government sanction, may perhaps mislead an intending buyer. Nowhere on the certificate would it show that the stock had been sold at a discount. It is true that the amount paid in on a stock and its real value have no permanent relation, as I shall try to show hereafter, but this is not generally appreciated and it may be that a buyer in purchasing stock, issued under Government sanction, at a discount would be led to believe that such stock had been sold at par and was worth that sum. In the case of shares with no par value this could not happen. A share should be what it purports to be. If it purports to represent $100. paid in, that amount should actually be paid in. If it purports to be, as would be the case with a share of no par value, only a participation certificate giving a proportionate interest in any profits that may be earned, it would be understood that this was its essential character. The Railroad Securities Commission in its report says that the absence of any attempt to base security issues upon valuation will emphasize the true character of our American railroad stocks as being essentially participation certificates, giving the right to a proportionate share of whatever profits may be earned rather than evidence that a certain specific amount of money had actually been invested in the property. It has

the merit of being an accurate declaration that in order to determine the value of the certificate an examination must be made by an intending purchaser into the value of the property. No one could have any excuse for claiming to have been misled. If only shares having a par value are to be issued then it is needless to say that the shares of carriers must necessarily sell at a considerable premium if money is to be raised in any manner other than by the sale of fixed interest-bearing bonds, for no stockholder or investor will purchase stock at par when the selling price in the market is at a discount. In the case of shares with no par value, however, the question of discount does not arise. The certificate is a participation certificate merely and can be sold at whatever prices carriers may deem proper, **subject always to the approval of the Interstate Commerce Commission.** If it be true, as I have stated, that the worse the financial position of a carrier the more is it forced to go into debt, if denied the right to sell at a discount shares having a par value, does it not follow that to deny to carriers the right, where permitted by State law to create and to dispose of shares with no par value, is to force them to embark on and continue in a course that sooner or later must lead to financial disaster. To the extent that we lessen debt we shall increase the power of the roads to raise money when the public needs added facilities and shall at the same time reduce the chances of default. In its report the Railroad Securities Commission says, among other things, "Railroad credit is an important asset to the entire country and it should not be wasted * * *. We are only suggesting that the present generation shall not be unmindful of its obligations to future users of transportation." In these two sentences is summed up my advocacy of permitting carriers to create an adequate base of capital for their credit superstructure.

(2) The second economic ground on which I base my advocacy and to which I referred at the outset is that there is no such thing as constant value,—that all value fluctuates with use, depending upon supply and demand, profitable employment of property and other factors. The mere fact that a share states that $100. has been paid in is of historical interest only, signifying that at the time of the issuance of the share there had been paid into the corporation an amount of money or other consideration equal to the par value of the share. Even in theory it purports merely to show that this was the amount originally paid by the subscriber when the road was built. Its face value does, however, not represent its money value as a share. The **real** value of the share depends upon the manner in which the money has been invested. Such value varies with the development of the property as a whole. If it has been wisely located and well managed it will be worth **more** than the amount it purports to represent and if it has been unwisely located or poorly managed it will be worth **less.** Any attempt to maintain a fixed relation between value and capitalization is wholly futile. Such a relation would be archaic almost from the outset because an adjustment of securities based upon the values of today might be wholly erroneous tomorrow. The constant variation in the cost of labor,

terminal lands, roadbed and equipment need only to be mentioned to show the fluctuating nature of value. Fluctuation in rates of interest is another important factor in determining value. There recently fell due a joint issue of bonds amounting to over $200,000,000. of the Northern Pacific and Great Northern Railroads. The bonds bore interest at 4% and were renewed at 6½%. The new bonds are, moreover, in part convertible into the bonds of the Great Northern Road bearing 7% interest. Had the old bonds fallen due five or ten years later the rate of renewal might have been no more than four per cent. This refunding at a higher rate of interest, due to existing market conditions, involving, as it does, a large increase in fixed charges, naturally diminishes the value of the equity in these properties and affects to that extent the value of the shares of the guarantor companies.

Also in quite another way does the prevailing rate of interest affect market value. For at a time when interest rates are low market values of securities are usually high and conversely at a time when interest rates are high, market values are usually low. The reason is obvious. When investors can purchase new investments bearing high rates of interest they will not pay the same prices for old ones bearing low rates of interest and holders of the latter who may wish to dispose of them must do so on terms that will tempt buyers. The scarcity or plethora of capital in its relation to demand therefore determines interest rates. I need not go into a detailed statement of *all* the factors that go to make up value, but enough has been said here to show that the value of shares will not remain constant at the

amount paid in but will fluctuate from the very hour of their issue. The Supreme Court had this clearly in mind when it said that "the value of property results from the use to which it is put and varies with the profitableness of that use, present and prospective, actual and anticipated * * *. There is no pecuniary value outside of that which results from such use." Any attempt, therefore, to preserve a definite relation between the amount of stocks and bonds that a carrier may have outstanding and the value of the property represented thereby is bound to fail, for the value of securities, once they are issued, is determined by conditions, which find expression on the exchanges or elsewhere in prices arrived at through private bargaining. There would appear to be, therefore, very little use in attempting to establish a relation, a departure from which is bound to take place almost from the start.

. . . . .

The Railroad Securities Commission in its report says "The issue of stock without par value offers special facilities for consolidation and **reorganization.**" The Transportation Act, providing as it does for the ultimate consolidation of many of the carriers into large systems, makes now a very practical question of what was then largely a theoretical one, because few, if any, railroad consolidations were then going on or contemplated.

The stocks of almost all carriers are at present selling below par. Some of them in times past have sold considerably above par and large amounts of stocks were acquired by present holders at high prices. Shareholders are loth in a consolidation or in a reorganization to accept a

smaller number of shares than was held by them before such consolidation or reorganization. It is almost certain that the shares of different carriers to be consolidated have not exactly the same value. In the apportioning the of shares of consolidated companies to shareholders of constituent companies, the ability to issue shares of no par value becomes manifest. On this point the Railroad Securities Commission says:

> "Where two roads have consolidated whose shares have different market values, it has been the custom to equalize the difference by the issue of extra shares of the consolidated company to the owners of the higher priced stock. This practice has always tended to produce increase of capital issues, and may readily cause the new stock to be issued for a consideration less than its par value. The only alternative was to scale down some of the old stocks; and this often involved serious difficulties, both of business policy and of law. By the simple expedient of omitting the dollar mark from the new shares, the number can be adjusted to the demands of financial convenience, without danger of misrepresentation or suspicion of unfairness to anyone."

The necessity for **reorganization** may be due to bad management, to a bad financial structure growing out of lack of foresight or restrictive laws, to the falling due of a large bond issue at a time of panic, to the inability to fund a floating debt, to a temporary impairment of earnings due to crop failures or other natural causes, inadequate provision for terminals and for depreciation and obsolescence of roadbed and equipment, but the **potential** earning power may still be unimpaired and with new capital provided value may still be realizable upon existing shares. Shareholders being of a hopeful nature are usually willing to subscribe to fresh capital if they are permitted to acquire an amount of shares in the new company equal to that held by them in the old. Such shares would at the outset necessarily sell at less than par in the case of shares having a par value. Why not, therefore, require in such cases that the shares should be of no par value, leaving it to every prospective shareholder thereafter to determine the value back of the shares. To raise money in a reorganization is always difficult and to avoid paying a high rate of interest it is essential that stockholders be induced to contribute new money at comparatively low rates. This they are frequently willing to do if given an equal number of shares of new stock for their old. The Commission, by granting the issue of shares of no par value, enables the creditors and stockholders to come to an amicable agreement, enables additional money to be raised, a thing clearly in the public interest, and assumes no responsibility for the value of the shares created. Perhaps the Chairman will bear with me while I read one more extract from the report of the Railroad Securities Commission.

> "In the case of **reorganizations**, the advantage of shares without par value is even more obvious. It is here that the necessity and justice of getting money from stockholders is greatest. It is here that the impossibility of getting them to pay par for new shares is most conspicuous. We believe that in such

> cases the public interest would be subserved and the speedy rehabilitation of the roads promoted, by requiring the conversion of the common stock and encouraging the conversion of the preferred stock into shares without par value; the certificates simply indicating the proportionate or preferential claims of the holders upon assets and upon such profits as might from time to time be earned."

A reason frequently adduced against permitting shares of no par value to be issued, is the danger of possible inflation. I think that this argument is based on the misconception that shares are anything other than participation certificates in the profits of the business after the payment of interest on debts. Shareholders will always be jealous of permitting others to acquire shares in their company except at full market value, nor is it likely that they will permit the issue of shares to themselves at prices so much below market value as seriously to impair the market or other value of their holdings.

. . . . .

On the grounds, therefore, not only of sound finance, but also in order that the economic principle of fluctuating value may be clearly brought to the mind of intending investors so that no claim can be made on their part of having been misled by the dollar mark on a stock certificate into the belief that they were purchasing value that did not exist, I strongly urge upon the Commission the adoption of the principle **permitting** the issue of shares of no par value when so requested and of **encouraging** wherever possible the creation of such shares.

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